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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Significant Index Numbers:.
4941.00-00
4945.00-00

Date:
MAY 15 2001

Contact Person:

ID Number:

Contact Telephone:

Reference:
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Dear Sir or Madam:

This is in response to M's request for certain rulings as supplemented and amended under sections 501(c)(3), 4941 and 4945 of the Internal Revenue Code submitted by M's legal representative. M has requested certain rulings that the terms of a settlement agreement between M and certain interested parties will not constitute acts of self-dealing as described in section 4941 of the Code and result in taxable expenditures under section 4945.

Facts:

M has been recognized as exempt under section 501(c)(3) of the Code and classified as a private foundation under section 509(a).

P died with a Will, and in addition to the assets in his probate estate, P also left assets owned by an irrevocable trust and by a revocable trust "O" (which became irrevocable at P's death). All of the assets of both trusts are includable in P's estate for federal estate tax purposes. P and his late wife, were the sole contributors to M. Therefore, P is a "substantial contributor", with respect to M, within the meaning of sections 507(d)(2) and 4946 (a)(1)(A) of the Code.

A serves as the administrator of P's estate. A is unrelated to P and Q. A has the power to reallocate property in P's estate on behalf of M and Q.

Q are the grandchildren of P. Therefore Q, as the grandchildren of P, are disqualified persons with respect to M pursuant to section 4946(a)(1)(d) of the Code.

S, T, and U serve as the trustees of O.

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M states that P's objective in creating M was to provide with the opportunity to enhance their education, thus better enabling them to make a contribution to the . As stated in one of M's recent Annual Reports,

M's principal grant program is offered each year to three competitively selected from each of the . The grants are educational grants for two years of graduate study and other educational experiences in a foreign country. The grant recipients are nominated by M makes the final selection of scholars, and approves their foreign universities.

M's Board of Directors consists of members, which includes S, T, and R, who are who were grant recipients of M's grant program. B serves as M's secretary and treasurer.

Approximately 85% of P's total gross estate consist of the value of O. Of that amount, about 96% is comprised of two assets: shares of stock in V, a publicly traded corporation, and 100% of the common stock of W, substantially all of the assets of which consisted of additional shares of V. The beneficiaries of the assets in O are M and Q. M represents that the current value of these assets is currently approximately 60% higher than it was on the date of P's death.

M states that the activities conducted by W were always limited to holding stock of other corporations and other non-business assets. M states that W never conducted any active business, and has filed income tax returns as a personal holding company.

According to V's Annual Report, the stock owned by W and the stock owned directly by O comprise about v percent of the total V stock outstanding. Substantially all of the income of W consists of dividends received with respect to the V stock.

Upon P's death, O provided, in part, that: (1) all shares of V held directly by O were to be contributed to W (2) all class B shares of W were to pass to Q in equal shares; and (3) all of the class A shares of W as well as all other assets of O were to pass to M.

M states that prior to December 1985, the class B common shares held sole voting rights in W. In December, 1985, P executed documents which purported to change the voting rights of W by giving one vote to each share of Class A stock, and two votes to each share of Class B stock. Following P's death; Q challenged the

validity of one of the documents P signed in the prior year and the change in the voting rights of the class A shares of W. Q contended that the document is invalid due to legal deficiencies. Q took the position that due to the invalidity of this document, voting control of W never changed, and continued to reside with the class B shares.

M's position was that the documents in question were valid and effective, and that the claims submitted by Q are barred for other reasons as well. As a result, M's class A shares possessed 80% of the voting power, and thus control of W.

Q subsequently filed suit against M, W, and O, in the court with jurisdiction over P's estate (located in the county where P resided at the time of his death), seeking: (1) a declaratory judgment that the change in voting rights is "null and void and of no force or effect;" and (2) an injunction to prevent the revocable trust and M from voting the Class A shares. Q later amended the lawsuit to name S, T and U, the individual trustees of the revocable trust, as defendants.

Q filed another lawsuit against S (who is also a director of M) in his capacity as trustee of O, in his capacity as a director of W, and in his individual capacity. In this lawsuit, Q claimed that S breached his fiduciary duties and intentionally interfered with the Q's expectancy of inheritance. The revocable trust provides for indemnification of a trustee who is sued under these circumstances against "legal fees, cost of settlement, and/or any other expenses relating to said lawsuit." However, there are exceptions to the coverage of these indemnification provisions, including an exception for willful misconduct. M states that since it is the beneficiary of a large percentage of the assets in the revocable trust, the costs of any such indemnification would be borne predominantly by M.

M states that after taking into account the costs of pursuing and defending the lawsuits filed by Q, the time and energy that is consumed by the litigation process, and the other risks, and wishing to avoid the uncertainties inherent in judicial resolution, the parties have entered into a settlement agreement. M states that the settlement agreement is the result of extensive and intensive negotiations, which occurred over a period of approximately four months, and it reflects significant compromises made by each of the parties to the agreement. The settlement agreement has been approved by a court with jurisdiction over the administration of P's estate.

M states that the net effect of the settlement, assuming the parties' projections are correct, will have the result of dividing the assets of O approximately 80% in value to M and 20% in value to Q, excluding for this purpose the amounts required to be paid for taxes and other expenses. The principal terms of the Settlement Agreement, which have been approved by the court having jurisdiction over the estate, include the following:

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1. Sale of W stock. The parties authorized the Trustees to sell all of the shares of W to an unrelated purchaser. The agreement required that none of the parties (nor any of their respective officers, directors, or trustees) might receive any compensation or fee in connection with the sale.

2. Private Letter Ruling and Court Approval of Settlement. The parties agreed that they would seek a private letter ruling from the Service and would cooperate in the preparation of the ruling request. The parties also authorized the Personal Representative to seek approval of the settlement agreement by the court with jurisdiction over the administration of the estate. The parties agreed upon a procedure under which the Personal Representative can terminate the agreement if he becomes convinced that (i) the Service will not issue the requested ruling, (ii) the Court will not approve the settlement, (iii) the court having jurisdiction over either court preceding will not approve the dismissal of that action (to the extent that such approval is necessary), or (iv) an objective condition upon which the requested ruling is expressly made contingent by the IRS will not be satisfied.

3. Stock Owned by O. The Trustees of O will retain the W stock owned directly by O, rather than contributing such stock to W (as called for by the terms of O). The O Trustees will retain that stock unless authorized to dispose of it by Q and M; except that if substantially all the stock of W is acquired by a third party, O may dispose of its stock in that transaction.

4. Segregation of Certain V Stock for Grandchildren and Other Purposes. Upon the execution of the Agreement, the Trustees were required to, and did, segregate internally within O certain shares of V stock owned directly by O. The number of shares so segregated was the number determined to be adequate (i) to pay the generation-skipping transfer tax and any and all state and federal estate and inheritance taxes and interest related thereto, and (ii) to provide x shares of such V stock (after the payment of such taxes) for the benefit of Q. Dividends on either portion of these segregated shares follow the respective segregated shares. Proceeds from the sale of the segregated shares were also segregated.

5. Distributions to Q Prior to Issuance of Requested Ruling. Pursuant to the Settlement Agreement, the following distributions were made to Q, (the grandchildren) out of the x shares prior to the issuance of the private letter ruling: (a) y shares of V stock to each of the grandchildren immediately after the signing of the Settlement Agreement, and (b) z shares of V stock to each of the grandchildren immediately upon the closing of the sale of the W stock and the receipt by O of the full payment on that sale. To guard against any possibility of Q receiving more than they are entitled to, the

settlement agreement provides that if it is terminated and the appropriate court determines that Q, the grandchildren of P, are entitled to receive less than the value (as of the date of P's death) of the property distributed to them under (a) and (b) above, Q shall be required to refund to O any amount that exceeds the amount to which they were determined to be entitled.

6. Distribution to M Prior to Issuance of Private Letter Ruling. Upon the closing of the sale of the W stock and the receipt by O of the full payment on that sale, a distribution in cash, marketable securities or any combination thereof was to be made to M. This distribution requirement has been fulfilled by a distribution of cash.

7. Litigation Stayed. In order to permit the sale of W stock and the delivery of clear title to its purchaser, W was dismissed from the first court proceeding, and the claims against S in his capacity as a W officer and director in the second court preceding have been dismissed. The other pending litigation is being held in suspense until the ruling is issued or the settlement agreement is terminated.

8. (a) Dismissal of Litigation and Delivery of Releases. If the ruling is issued and the Court approves the settlement agreement, the lawsuits filed by Q will be dismissed with prejudice by consent orders. Also, effective upon the final dismissal of both of these actions, S will resign from his positions as an officer and director of M and will agree not to serve in any further capacity with M. The parties also agree to execute general releases of one another, including releases of the Trustees, the officers and directors of M, and the Personal Representative.

(b) Distribution to Grandchildren. After both lawsuits filed by Q have been dismissed and the general releases delivered, the escrow agent will distribute the remaining balance of the x shares (or the sale proceeds of those shares, if sold, and the net income from such shares) to Q, the grandchildren.

(c) Preparation of Amended Estate Tax Return. A, as the Personal Representative, shall file amended federal and state estate tax returns consistent with the Settlement Agreement and shall pay, from the funds segregated for such purpose, the resulting generation-skipping transfer tax and estate taxes.

M has obtained an opinion from an independent expert with regards to the value of M's interest in O. M represents that taking into account the facts, including the risks of litigation, and the legal fees that would likely be incurred over the period of time required for litigation, M is receiving an amount, which equals or exceeds the fair market value of its interest before the execution of the settlement agreement.

M states that it believes this settlement will greatly advance its ability to perform its charitable purposes, as it will provide M with liquid funds in place of an illiquid interest in a privately-held corporation co-owned by disqualified persons. Further, the settlement would end the costly drain of legal fees and other expenses that will otherwise be required to continue this protracted litigation to its ultimate conclusion. M also states that the settlement would eliminate M's risk of an adverse judicial decision on the issues in litigation that could cost M far more than the cost of the settlement.

Applicable Law:

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated for religious, charitable, or educational purposes.

Section 4941(a)(1) of the Code provides for the imposition of tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1)(A) of the Code provides that the term "self-dealing" means any direct or indirect sale or exchange, or leasing of property between a private foundation and disqualified person.

Section 4941(d)(1)(E) of the Code states that the term "self dealing" means any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4945(d)(5) of the Code provides that the term "taxable expenditure" does not include amounts paid or incurred by a private foundation as a grant to another organization for purposes specified in section 170(c)(2)(B).

Section 4946(a)(1)(A) of the Code provides that the term "disqualified person" means, with respect to a private foundation, a person who is a substantial contributor to the foundation.

Section 4946(a)(1)(B) of the Code provides that the term "disqualified person" means, with respect to a private foundation, a person who is a foundation manager to the foundation.

Section 4946(a)(1)(d) of the Code provides that for purposes of subsection (a)(1), the family of any individual shall include only his spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren.

Section 53.4941(d)-1(b)(3) of the regulations provides that the term "indirect self-dealing" shall not include a transaction with respect to a private foundation's interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor's death), regardless of when title to the property vests under local law, if--

(i) The administrator or executor of an estate or trustee of a revocable trust either--

(a) Possesses a power of sale with respect to the property,

(b) Has the power to reallocate the property to another beneficiary, or

(c) Is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);

(ii) Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust) or over the private foundation);

(iii) Such transaction occurs before the estate is considered terminated for Federal income tax purposes pursuant to paragraph (a) of Sec. 1.641(b)-3 of this chapter (or in the case of a revocable trust, before it is considered subject to section 4947);

(iv) The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and

(v) With respect to transactions occurring after April 16, 1973, the transaction either--

(a) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,

(b) Results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or

(c) Is required under the terms of any option, which is binding on the estate (or

trust).

Section 53.4941(d)-2(f)(3) of the Foundation and Excise Tax Regulations provides that except as provided in Sec. 53.4941(d)-3(c), section 4941(d)(1) shall not apply to the indemnification by a private foundation of a foundation manager, with respect to his defense in a judicial or administrative proceeding involving chapter 42 or State laws relating to mismanagement of funds of charitable organizations, against all expenses (other than taxes, penalties, or expenses of correction) including attorneys' fees, if--

(i) Such expenses are reasonably incurred by him in connection with such proceeding, and

(ii) He is successful in such defense, or such proceeding is terminated by settlement, and he has not acted willfully and without reasonable cause with respect to the act or failure to act which led to liability for tax under chapter 42. Similarly, except as provided in Sec. 53.4941(d)-3(c), section 4941(d)(1) shall not apply to premiums for insurance to reimburse a foundation for an indemnification payment allowed pursuant to this subparagraph.

Section 53.4945-6(b)(1) of the regulations provides that generally expenditures (and reasonable expenses incidental thereto) to acquire investments entered into for the purpose of obtaining income or funds to be used in furtherance of purposes described in section 170(c)(2)(B) ordinarily will not be treated as taxable expenditures under section 4945(d)(5).

Analysis:

M represents that the settlement agreement will advance its ability to perform its charitable purposes under section 501(c)(3) of the Code, since it will provide M with liquid funds rather than a stock interest in a privately-held corporation co-owned by Q, "disqualified persons" described in section 4946(a)(1)(d).

M and Q are the beneficiaries named in P's will. Prior to the execution of the settlement agreement, M's interest in the assets of P's estate included assets held in O. M has obtained the opinion of an independent expert with regards to the value of its P's estate, which includes assets held in O. Under the settlement agreement M, will receive 80% of the assets held in O. M represents that considering all of the relevant facts and circumstances, including the risks and duration of litigation, the fair market value of its expectancy in P's estate prior to the agreement equals or exceeds the fair market value of the assets it will receive pursuant to the settlement agreement pursuant

to section 53. 4941-1(b)(3) of the regulations.

A settlement agreement has been entered into, involving property allocation changes among P's estate beneficiaries, including Foundation M and Q, disqualified persons within the meaning of section 4946 of the Code. Under the terms of P's will, M and Q are entitled to receive certain investment interests held by O, which is part of P's estate. A, as administrator of P's estate, has the power to reallocate the property held by P's estate on behalf of M and Q, pursuant to section 53.4941(d)-1(b)(3)(i) of the regulations. Further, the probate court with jurisdiction over the administration of P's estate has approved the settlement agreement between the parties, including M and Q, pursuant to section 53.4941(d)-1(b)(3)(ii) of the regulations. P's estate has not been terminated for federal income tax purposes pursuant to section 53.4941(d)-1(b)(3)(iii). Finally, under the facts represented the fair market value and liquidity requirements will be satisfied pursuant to sections 53.4941(d)-1(b)(3)(iv) and (v).

Reasonable and necessary expenditures incurred by M relating to the negotiations, preparation, and execution of the settlement will not be treated as taxable expenditures pursuant to section 53-4945-6(b)(1) of the regulations.

Holdings:

Based on the particular facts and circumstances above, we rule as follows:

(1) The settlement agreement will not give rise to acts of self-dealing under section 4941 of the Code.

(2) The settlement agreement will not adversely affect M's tax-exempt status as an organization described in section 501(c)(3) of the Code.

(3) The settlement agreement will not give rise to taxable expenditures under section 4945 of the Code.

This ruling does not purport to rule on any other provisions of the Code. This ruling is directed only to the organization and the disqualified persons that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

This ruling is limited to the applicability of the provisions of sections 501(c)(3), 4941, and 4945 of the Code and does not purport to rule on any facts that were not presented in the ruling request as supplemented. Also, in this ruling, we have not determined whether the methodology you or your independent appraisers are using to determine fair market values is proper. We merely have accepted your representations

that the transactions will reflect fair market value and that you will incur reasonable and necessary expenses.

Sincerely yours,

Robert C. Harper, Jr.

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3